

November 12, 2013

CFTC Proposes Revised Position Limit Rules

On November 5, the Commodity Futures Trading Commission (CFTC) voted to propose rules that would expand the scope of the CFTC's speculative position limit requirements for futures, options and swaps. On the same date, the CFTC also approved a separate proposal addressing the aggregation of positions across accounts with common ownership or control. Katten issued a [Client Advisory](#) on November 7 discussing the proposed aggregation requirements and is now issuing this advisory to address the proposed position limit rules. The proposed position limit rules would replace the CFTC's Part 151 rules, which were adopted on October 18, 2011, and vacated by the US District Court for the District of Columbia on September 28, 2012.¹

New Position Limit Rules

Consistent with the approach taken in the vacated Part 151 rules, the CFTC proposal identifies 28 core referenced futures contracts,² and would apply aggregate position limits on a futures equivalent basis across all "referenced contracts"—*i.e.*, futures, options or swaps that are: (i) directly or indirectly linked to the price of a core referenced futures contract; or (ii) based on the price of the same underlying commodity for delivery at the same delivery location(s) as that of a core referenced futures contract. The revised rules would impose separate position limits for spot-month contracts, non-spot-month contracts and an overall limit that would be applied across all spot and non-spot contract months for all referenced contracts.

Spot-Month Limits. The CFTC proposal would establish separate spot-month limits for physically delivered and cash-settled futures, options and swaps. The proposed rule includes preliminary spot-month limits based on the futures exchanges' current spot-month limits. These limits would become effective 60 days after final rules are published in the *Federal Register* and thereafter would be adjusted, at least every other calendar year, to a level no greater than one-quarter of the deliverable supply. The CFTC has proposed a conditional exemption from the spot-month limits that would allow a person to own or control up to five times the spot-month limit for cash-settled contracts, if the person does not also hold or control spot-month positions in the physically delivered contract and makes daily reports to the CFTC.

¹ See *International Swaps and Derivatives Association v. United States Commodity Futures Trading Commission*, 887 F. Supp. 2d 259 (D.D.C. 2012). The CFTC has announced that it will withdraw its appeal of the district court's decision.

² These core referenced futures contracts include: Chicago Board of Trade Corn, Oats, Rough Rice, Soybeans, Soybean Meal, Soybean Oil and Wheat; Chicago Mercantile Exchange Feeder Cattle, Lean Hogs, Live Cattle and Class III Milk; Commodity Exchange, Inc. Gold, Silver and Copper; ICE Futures U.S. Cocoa, Coffee C, FCOJ-A, Cotton No. 2, Sugar No. 11 and Sugar No. 16; Kansas City Board of Trade Hard Winter Wheat; Minneapolis Grain Exchange Hard Red Spring Wheat; and New York Mercantile Exchange Palladium, Platinum, Light Sweet Crude Oil, New York Harbor No. 2 Heating Oil, New York Harbor Gasoline Blendstock and Henry Hub Natural Gas.

For more information, please contact your Katten Muchin Rosenman LLP attorney, or any of the following members of the **Financial Services** practice.

Arthur W. Hahn
+1.312.902.5241
arthur.hahn@kattenlaw.com

Henry Bregstein
+1.212.940.6615
henry.bregstein@kattenlaw.com

Blake J. Brockway
+1.312.902.5438
blake.brockway@kattenlaw.com

Wendy E. Cohen
+1.212.940.3846
wendy.cohen@kattenlaw.com

Guy Dempsey
+1.212.940.8593
guy.dempsey@kattenlaw.com

Lisa A. Dunsky
+1.312.902.5594
lisa.dunsky@kattenlaw.com

Kevin M. Foley
+1.312.902.5372
kevin.foley@kattenlaw.com

Jack P. Governale
+1.212.940.8525
jack.governale@kattenlaw.com

Christian B. Hennion
+1.312.902.5521
christian.hennion@kattenlaw.com

Carolyn H. Jackson
+44.0.20.7776.7625
carolyn.jackson@kattenlaw.co.uk

Ross Pazzol
+1.312.902.5554
ross.pazzol@kattenlaw.com

Kenneth M. Rosenzweig
+1.312.902.5381
kenneth.rosenzweig@kattenlaw.com

Fred M. Santo
+1.212.940.8720
fred.santo@kattenlaw.com

Allison C. Yacker
+1.212.940.6328
allison.yacker@kattenlaw.com

Lance A. Zinman
+1.312.902.5212
lance.zinman@kattenlaw.com

www.kattenlaw.com

Non-Spot-Month Limits. The proposed rule also would establish single-month and all-months-combined position limits for all referenced contracts. These levels would be adjusted at least once every other year and would be set in an amount equal to the greater of (i) 10 percent of the first 25,000 contracts of the average all-months-combined aggregate open interest, plus 2.5 percent of the average all-months-combined aggregate open interest in excess of 25,000 contracts; or (ii) the spot-month limit; or (iii) 1,000 contracts for agricultural contracts or 5,000 contracts for exempt commodities.³

Grandfathering of Existing Positions. The CFTC proposal would allow traders to hold swap positions in excess of the new position limits as long as they entered into these positions in good faith prior to the implementation of the revised position limit rules. A trader relying upon this relief would not be permitted to increase the size of its position after the new limits take effect.

Exemption for Bona Fide Hedging Positions

Under the CFTC proposal, the definition of bona fide hedging in CFTC Regulation 1.3(z) would be replaced by a new definition in CFTC Regulation 150.1. With the following exceptions, the proposed definition of bona fide hedging is substantially similar to the current definition: *first*, positions used to offset pass-through swaps are now included in the definition of bona fide hedging; *second*, the process for obtaining an exemption for a non-enumerated hedging position would change; and *third*, the CFTC's interpretation of the "economically appropriate" component of the bona fide hedging definition would dramatically affect a market participant's ability to separately hedge its long and short positions. As with the existing definition, bona fide hedging positions would have to be incidental to commercial cash, spot or forward operations and be established and liquidated in an orderly manner.

Hedges for an excluded commodity⁴ would additionally be required to be: (i) economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise and fall within an enumerated hedging category; or (ii) recognized as a bona fide hedging or risk management position by the rules of a designated contract market or swap execution facility. Appendix A of the proposed position limit rules provides guidance for risk management exemptions.

Bona fide hedging positions for physical commodities would be required to: (i) represent a substitute for transactions in the physical marketing channel; (ii) be economically appropriate to the reduction of risks in a commercial enterprise; (iii) arise from the potential change in value of certain assets, liabilities or services; and (iv) fall within one of the enumerated hedging categories in CFTC Regulation 150.1 or qualify as an offset to a pass-through swap. To qualify as an offset to a pass-through swap, the position would be required to be held to reduce the risks of a swap that, at the time of the transaction, would qualify as a bona fide hedge for the counterparty. The exemption would not apply to risk-reducing positions that are held during the spot month or the last five trading days of an expiring contract.

Enumerated Hedging Positions. The proposal identifies the following types of enumerated hedging positions: (i) short positions used to hedge owned inventory and fixed-price purchases; (ii) long positions used to hedge fixed-price sales; (iii) long positions used to hedge unfilled anticipated requirements; (iv) long or short positions used to offset price risk by an agent that is responsible for marketing a cash market positions; (v) short positions used to hedge unsold anticipated production; (vi) long and short positions used to hedge offsetting purchase and sales at unfixed prices; (vii) short positions used to hedge anticipated royalty payments; and (viii) long or short positions used to hedge expected receipts or payments due under service contracts.

Non-Enumerated, Risk-Reducing Practices. Current exemptions granted under CFTC Regulation 1.47 for swap risk management will be revoked with respect to all swap positions entered into after the effective date of the final rules. Proposed CFTC Regulation 150.3 would allow market participants to request an interpretive letter concerning the applicability of an exemption or exemptive relief for risk management practices that do not fall within an enumerated exemption.

Financial Distress Exemption. Under the proposed rule, the CFTC has the authority to grant a financial distress exemption that would allow a person to acquire or take control of positions in the event of a potential default, bankruptcy or acquisition of an entity experiencing financial duress without violating the federal position limits.

³ The term "exempt commodity" means a commodity that is not an excluded commodity or an agricultural commodity.

⁴ Excluded commodity has the meaning given in Section 1a(19) of the Commodity Exchange Act.

Gross vs. Net Hedging. In a notable departure from the long-standing view of the CFTC and its predecessor agency, the Commodity Exchange Authority, the proposed rule includes guidance that may limit the ability of commercial enterprises to separately hedge their long and short cash market exposures. Under the CFTC proposal, in order for a position to be economically appropriate to the reduction of risks in a commercial enterprise, the enterprise would be expected to take into account all inventory or products that it owns, controls or has contracted to purchase or sell at a fixed price. If adopted by the CFTC, this revised interpretation is likely to have an adverse impact on commercial hedgers with long and short cash market positions that, for a variety of legitimate commercial reasons, only use derivatives to hedge one side of their cash market exposure.

Exchange-Set Speculative Position Limits

Under the proposed rule, designated contract markets and swap execution facilities must adopt position limits at a level no higher than the federal limit for all referenced contracts, but position accountability requirements may be adopted in lieu of position limits for excluded commodities, as well as for physical commodities that are not subject to a CFTC position limit. A designated contract market or swap execution facility that adopts position accountability levels may be required to adopt spot-month limits in certain circumstances. The CFTC proposal also requires designated contract markets and swap execution facilities to adopt aggregation rules and bona fide hedging exemptions that are at least as stringent as CFTC requirements. The proposed rule would also allow designated contract markets and swap execution facilities to adopt risk management exemptions for excluded commodities.

Related Reporting Requirements

The proposal also would make conforming changes to the CFTC's reporting rules. Under the revised rules, market participants would use revised CFTC Forms 204 and 304 to report cash market positions. Market participants would no longer be able to exclude certain products or by-products in determining cash positions for bona fide hedging purposes, and could instead only exclude quantities that are *de minimis*, impractical to account for, or on the opposite side of the market as the participant's hedging position. Cash positions related to conditional spot-month exemptions, pass-through swap exemptions and anticipatory hedging exemptions would be reported on new CFTC Forms 504, 604 and 704, respectively.

Revised Aggregation Requirements

As discussed in detail in the [Katten Client Advisory](#) of November 7, 2013, the CFTC also issued a proposal that addresses the manner in which market participants must aggregate their positions for purposes of determining whether they are in compliance with the CFTC's position limit rules. Under the CFTC's current rules, a trader is required to aggregate, for purposes of applying the speculative position limits, all positions in accounts in which the trader either (i) holds direct or indirect ownership of 10 percent or more, or (ii) controls trading by power of attorney or otherwise, subject to certain limited exceptions. The proposed rules retain but modify many of the existing exemptions to the aggregation requirements, including those for independent account controllers, passive pool participants and futures commission merchant customer trading programs. The CFTC proposal would create new disaggregation exemptions for persons who own 10 percent to 50 percent of another entity that itself holds positions that are subject to position limits, as well as a stricter exemption for persons who own more than 50 percent of another entity. Other proposed exemptions would address underwriting and broker-dealer activities and entities that may be prohibited by law from sharing position information.

Katten

KattenMuchinRosenman LLP www.kattenlaw.com

AUSTIN | CENTURY CITY | CHARLOTTE | CHICAGO | HOUSTON | IRVING | LONDON | LOS ANGELES | NEW YORK | ORANGE COUNTY | SAN FRANCISCO BAY AREA | SHANGHAI | WASHINGTON, DC

Published as a source of information only. The material contained herein is not to be construed as legal advice or opinion.

©2013 Katten Muchin Rosenman LLP. All rights reserved.

Circular 230 Disclosure: Pursuant to regulations governing practice before the Internal Revenue Service, any tax advice contained herein is not intended or written to be used and cannot be used by a taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer. Katten Muchin Rosenman LLP is an Illinois limited liability partnership including professional corporations that has elected to be governed by the Illinois Uniform Partnership Act (1997). London: Katten Muchin Rosenman UK LLP.